Why India Represents an Opportunity Today

Published July 25, 2016

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I recently had an opportunity to speak with Morgan Stanley's Head of India Research, Ridham Desai. We discussed a range of issues covering India's macroeconomics in the wake of global events such as the resignation of Dr. Raghuram Rajan and Brexit. Clearly, there has been no shortage of excitement with respect to India. **Current Market Cycle** Desai believes India is in great structural shape from a medium- to long-term perspective. He said the current growth cycle in India is turning around, though it is still weak and spotty. There has been a sharp turnaround in capital expenditures, engineered by the government, especially in the infrastructure sector. Private sector capex still appears weak, and India's industry has been facing global headwinds. Overall, Desai described India as experiencing a U-shaped recovery and believes it will take more than 12 months for private capex to pick up, as current capacity utilization is in the low 70% range. The cause of this is partially related to weak global demand for exports. Desai believes that the service sector, which accounts for nearly 60% of India's gross domestic product (GDP) (manufacturing represents 25% and agriculture the final 15%), would continue to push growth higher. Retail loan growth, measured at 20%, is at a multiyear high, leading to sharp pickup in consumer infrastructure—construction of shopping malls, multiplexes and auto showrooms. Job indexes are also up by 25% year-on-year. **Resignation of Dr. Rajan 'Rexit' and the Future of India's Monetary Policy** Since India's prime minister, Narendra Modi, took office two years ago, he and Rajan have worked as a tag team, leading to first stabilize the rupee and then to India becoming an outperformer in emerging markets (EM). What's next? When these two gentlemen started their respective jobs, India's macro situation was very fragile, with a large current account deficit, high inflation, high deficit and low growth. Since then, the Reserve Bank of India (RBI) and the government have worked in tandem, keeping real rates low and later compressing the fiscal deficit, which led to an enormous improvement in the macro fundamentals of India. Desai also believes that the RBI has a strong track record with a much longer history compared to past governments, and thus a current change in leadership is not surprising. Desai's initial worries of a knee-jerk reaction by the market proved unfounded, and markets have remained steady since Rajan's exit news broke. Fortunately, current deputy governor Urjit Patel, a key member in policy making, has extended his term for three more years. The new governor will most likely be a macroeconomist, according to Desai. Thus, we should expect a similar monetary policy while the government continues to focus on foreign direct investment (FDI), liberalization and other reforms. Further, Morgan Stanley believes another 50 basis points (bps) in rate cuts between now and March of next year is possible, subject to a decent monsoon season. **Building on an Effective Track Record of Collaboration: The Story of Food Prices** A large part of the decline in inflation can be attributed to the decline in food prices—and the government played a key role. Desai explained why negative real rates and increasing food prices were responsible for high inflation. The RBI was effective in controlling the first issue while government fixed the second. **Infrastructure,**

Infrastructure, Infrastructure: Progress Being Made! In Desai's assessment, the current government has been working at a phenomenal scale in building public infrastructure. Last year, India completed 6,000 km (approximately 3,700 miles) of highway construction, about three times the annual pace of the last 10 years. The target for this year: 15,000 km (more than 9,300 miles). If only 80% of the initial target were to be achieved, it would still be equivalent to the amount of highway construction done in the previous six to seven years in a single year. Railroads are another sector in which massive public sector capex has occurred over the last year. **Time to Take Action: What Equity Over-Weights Make Sense?** Throughout our conversation, Desai emphasized how retail loans could be one of the key drivers of growth. Private banks have a key exposure to the retail segment and thus would be a market segment that stands to outperform. Desai also highlighted India's household-credit-to-GDP ratio, currently at 13% (among lowest in the world), which could double in the next few years, potentially leading to 20% CAGR growth for retail banks. Read our analysis of private banks in India. In Desai's opinion, the Consumer Discretionary sector had favorable valuations, and cyclically near-term earnings look stronger. Finally, he thinks Industrials engaged in building infrastructure could be attractive too. Overall, Desai and I agreed that getting 7.5% growth in the current global environment is difficult. India currently stands out as a beacon of growth for investors who are willing to stomach some volatility and potentially would be rewarded with strategic growth, driven by vibrant demographics and low debt ratios. ***Unless otherwise noted, data sources are Bloomberg and Morgan Stanley, as of July 8, 2016.***

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Investments focused in India increase the impact of events and developments associated with the region, which can adversely affect performance.